

85-1062

## ROUTING AND RECORD SHEET

SUBJECT: (Optional)

House Hearing on Supplemental Retirement

FROM

Legislative Liaison

DATE

2 April 1985

TO: (Officer designation, room number, and building)

DATE

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Attached are the statements for the record from today's House Post Office / Civil Service Committee Hearing on supplemental retirement. Additional information will soon follow. (Hearings will continue 3, 23 and 25 April)

# House of Representatives

## Committee on Post Office and Civil Service

Washington, D.C. 20515

TELEPHONE (202) 225-4034

### COMMITTEE ON POST OFFICE AND CIVIL SERVICE

#### HEARING ON SUPPLEMENTAL RETIREMENT PLAN

Tuesday, April 2, 1985

#### WITNESS LIST

1. Mr. Kenneth Shapiro, President, Hay/Huggins Company, Inc.;  
Mr. Edwin Hustead, Senior Vice President, Hay/Huggins  
Company, Inc.; and  
Mr. Gregori Lebedev, Director of Governmental Consulting  
Services, Hay Associates.
2. Honorable Donald J. Devine, Director-designate, Office of  
Personnel Management
3. Honorable Charles A. Bowsher, Comptroller General of the  
United States, General Accounting Office

♦.

**HAY**

PRESENTATION BEFORE THE  
POST OFFICE AND CIVIL SERVICE COMMITTEE  
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

BY

KENNETH SHAPIRO, F.S.A., M.A.A.A.  
PRESIDENT  
HAY/HUGGINS COMPANY, INC.

APRIL 2, 1985

Presentation before the  
Post Office and Civil Service Committee  
of the United States House of Representatives

by

Kenneth Shapiro, F.S.A., M.A.A.A.  
President  
Hay/Huggins Company, Inc.

April 2, 1985

Mr. Chairman:

We are delighted to appear again before your Committee to assist in the consideration of a supplemental retirement system for Federal employees covered by social security. We are impressed by the Committee's careful effort to consider all the issues involved in designing a new system. We hope the information and analysis we provided to the Committee over the past year have proven useful, and we thank the Committee for the opportunity to participate in these hearings.

The challenge facing this Committee and the Congress is to coordinate the retirement coverage provided to new Federal employees under two distinct systems -- social security and the Civil Service Retirement System (CSRS). It is a formidable challenge. Each system has its own complex array of benefits, requirements, and definitions. And while the two systems provide like benefits in some respects, they do so in different ways, at different ages, and with different effects on individual employees. Linking the two systems into a sensible and fair package of total Federal retirement coverage will not be simple, and there is no single, obvious solution.

Under the direction of this Committee, Hay undertook in 1984 to analyze the broad issues and the specific questions involved in retirement policy for Federal employees. In so doing, we followed the general approach that we would use as a starting point for establishing or revising retirement systems for large private

sector employers. With this foundation established, the Committee can now begin the difficult process of formulating and comparing actual legislative options. The analysis that you requested of Hay, and others, is now in hand and ready to be used in support of the Committee's deliberations.

We appear before the Committee today to discuss five major issues which the Committee will encounter in its consideration of proposals for a new supplemental retirement system. These are:

- total cost of the retirement system;
- general benefit design;
- portability and vesting;
- funding of supplemental benefits; and
- systems other than CSRS.

Achieving agreement in these fundamental decision areas will be a vital first step toward resolution of the many specific design questions ultimately facing the Committee and the Congress.

## TOTAL COST OF THE RETIREMENT SYSTEM

### Analysis of Cost

The first essential issue is the appropriate cost for the new system. A retirement system can be designed to meet any cost constraints. This can be accomplished by adjusting the basic benefit accrual rate, the retirement age, cost-of-living increases, or other features of the system. As a result, one approach available to the Committee is to decide on the appropriate total cost for the new system, and to assess all subsequent design issues within the context of this total cost target. We find that it is a common approach of private sector employers to establish a budget and design the plan within the budget.

In consultation with us, the Congressional Research Service (CRS) has developed a sophisticated computer model equipped to estimate the cost of any proposed supplemental retirement system. Using this model, CRS determined that the cost to the Federal government of the existing Civil Service Retirement System (CSRS) is 24.7 percent of payroll.

We are satisfied that this estimate accurately reflects the true long-term cost of the CSRS. The behavioral, demographic, and economic assumptions incorporated in the cost model are currently under review to ensure that all subsequent estimates provided to the Committee are based on the most up-to-date information available. This review may lead to a slight change in the estimated cost of the current CSRS. It will not, however, affect the relative costs of any new proposals compared to this current system baseline.

We understand that this computerized cost model has become, under the auspices of the Congressional Research Service, the accepted measurement device for legislative deliberations on alternative designs. Hay is, of course, gratified that the relevant Committees in both Houses have selected an analytic model based on

our actuarial expertise and modeling techniques. But more importantly, it is essential that one consistent model be used to avoid long and unproductive discussions about obscure technical differences between alternative models. Most sophisticated models will produce the same relative differences among the costs of the existing CSRS and alternative proposals for a new supplemental system. There are enough complex issues to resolve in plan design without getting needlessly bogged down in arcane, dilatory disputes about models, techniques, and assumptions.

### Normal Cost

I would like to review briefly the terminology used in our retirement cost measures. The figure we use to represent the cost of a system is the "entry-age normal cost," expressed as a percentage of payroll. This is a generally accepted measure within the actuarial profession. It portrays the long-term cost of a retirement system for a typical group of new employees. Thus, it is a very appropriate measure to use in considering any proposed system that will apply only to future, and recently new, employees of the Federal government.

Entry-age normal cost -- usually called simply "normal cost" -- is (1) the present value of all future benefits expected to be payable to a group of new employees and their dependents, divided by (2) the present value of the expected future salaries of these employees. In other words, if the normal cost is paid each year for all new employees, then the fund built from that money, plus its investment earnings, will be exactly sufficient to pay for the benefits earned by those employees.

A note of caution: the exact calculation of the normal cost for any system will be precisely correct only if the actuaries have predicted the future perfectly. There will be some "actuarial errors" in any set of economic, demographic, and behavioral predictions covering a 75-year period. However, the normal cost,

based on a careful review of relevant assumptions, is the most informative measure of the real long-term costs of alternative systems.

The total CSRS normal cost for generally available benefits is 31.7 percent of payroll. Federal employees currently contribute 7 percent of their salaries for these benefits, so the employer's normal cost is 24.7 percent of payroll. This constitutes the long-term cost to the taxpayers of the existing CSRS. It is the relevant benchmark for comparing the value and cost of CSRS benefits to the retirement benefits provided by other employers.

#### Other Cost Measures

Let me pause to put in perspective some other CSRS cost measures that might be presented to the Committee at these hearings. The Office of Personnel Management (OPM) valuations of the CSRS depict several items pertaining to the CSRS fund and accounts. These include the normal cost, the unfunded liability, and payments on the liabilities. The OPM has recently issued a report stating that the normal cost of the current system is 27.9 percent of pay. The difference between this figure and our estimate of 24.7 percent is attributable to OPM's use of more pessimistic economic assumptions. Given the range of reasonable economic assumptions, these two measures are, in fact, quite close. Both measures should produce similar relative differences for the costs of alternative systems.

Despite this technical difference in the two normal cost estimates, it is important to note that OPM and its consultants consider the normal cost to be the most appropriate measure of the cost of any proposed supplemental system. In their December, 1984 report, the OPM consultants, Towers, Perrin, Forster & Crosby, observe that "Since normal cost computations are perhaps the most reliable and consistent measure of the value of benefits provided by a retirement plan, alternative views of normal cost are used in this report."



OPM also reports that there is an unfunded CSRS liability of \$512 billion. The unfunded liability is the value of all benefits payable to employees and retirees, both already earned and projected for future service, minus the assets of the CSRS fund and the value of future normal cost payments. The unfunded liability is a measure of the money that would have to be paid to the system today, in addition to existing and anticipated funds, to cover the cost of all benefits that will be paid to retirees and employees over the next 75 years.

Taken out of context, the unfunded liability is a meaningless figure. It would be just as significant to add up the present value of all future social security benefits -- those who have done so report the unfunded liability of that system to be six trillion dollars -- or all future liabilities of any other financial system. The figure represents the current effect of a host of decisions about the benefits and financing of the system over the last 65 years. The important question is not the value of an isolated figure but whether or not there are built-in financing requirements that will adequately cover the evolving cost of the system.

In this case, we can definitely say that there are adequate measures to meet the cost of the system as it evolves. The annual OPM reports show, for instance, that current financing provisions will produce a growing fund each year for the next 75 years, and we can project a stable and growing fund each year thereafter.

Another very misleading cost figure is the estimated effect of funding the CSRS according to the Employee Retirement Income Security Act (ERISA) private sector requirements. If the private sector criteria were to be applied without revision, the first year cost to CSRS would be substantially higher than the level currently projected for this year. However, the cost would rapidly decline and eventually drop below the currently projected cost.

Hay submits that private sector financing criteria are inappropriate for CSRS. First, the criteria were enacted to ensure the solvency of the pension fund if the employer were to go out of business. While this need could be argued for even the largest and most stable private employer, it is not relevant to the Federal government. Were the government to go out of business, there would be problems much more severe than adequate financing of CSRS!

Second, the private sector funding criteria were not designed for a formally indexed system. While most employers provide intermittent cost-of-living adjustments (COLAs), they avoid prefunding the cost of inflation by only funding the increases after they have occurred. In this context, private sector plans are, in effect, partially funded under static economic assumptions. To suggest that the private sector rules should be construed to prefund all future inflation expected under CSRS is an inappropriate application of private sector funding rules.

We believe that estimates of the financing effects of ERISA requirements are irrelevant to discussions of the cost and funding of CSRS. The OPM reports show that the relatively stable financing of CSRS provided for by current law will be adequate to support the system.

#### Appropriate Cost for Supplemental System

Let us now return to the question of the appropriate employer cost for a supplemental retirement system for Federal employees. Our report on the total compensation of Federal employees shows that the cost of the CSRS is 24.7 percent of pay compared to an average private employer pension cost of 18.3 percent. Clearly, the CSRS is more valuable than systems available to most private sector employees. However, the difference is far smaller than some other analyses, such as that of the Grace Commission, would suggest. Hay believes that by applying consistent cost measures and considering all parts of the employers' retirement packages, most analyses would

be similar to ours. For instance, the TPF&C study for OPM shows cost differences that are much closer to our estimates than to those of the Grace Commission.

Hay's survey of the private sector, and similar surveys undertaken by CRS, OPM, and the General Accounting Office (GAO), show that a full career employee retiring at age 65 will actually receive higher benefits under a typical private sector retirement system than under CSRS. The reason that CSRS is more valuable in total is not the benefit level itself, but the fact that employees can receive a full benefit earlier than in most private sector plans and that the benefits are fully indexed after retirement.

I should pause here to note that a series of amendments has kept CSRS indexing below the full CPI increases since 1982. Further, there are several current proposals to restrict future COLAs. If future COLAs continue substantially below the full rate of CPI increase, then the CSRS system will be no more valuable than a typical private sector retirement system.

In sharp contrast to the higher value of the retirement system, Hay found that Federal compensation is below that of the private sector in virtually every other respect. For instance, Federal employee health benefits are 2.2 percent of pay less valuable, and Federal group life insurance 0.3 percent of pay less valuable, than comparable private sector benefits. When all employee benefits including pensions, are combined, Federal benefits exceed typical private sector benefits by less than 3 percent of pay.

Finally, we found that Federal employees were paid 10 percent less than comparable private sector employees in 1984. Taking the salary and benefit comparisons together, we estimate that private sector total compensation exceeds that of the Federal government by more than 7 percent. And, after the moderate 3.5 percent Federal pay increase this past January, we expect to find an even wider gap when we update our compensation comparisons this summer.

We suggest that in arriving at an appropriate target for the cost of a new supplemental system, the Committee be mindful of the fact that Federal retirement benefits now stand alone as practically the only element of compensation ahead of the private sector. If the cost of the new retirement system were, for instance, set equal to the value of the average private sector retirement system, then the total compensation of new Federal employees would lag the private sector by more than 15 percent.

#### Allocation of Cost Among System Components

Once an appropriate total cost is determined, the next question is the allocation of the cost among the several elements of the retirement system. One element -- the social security system -- is fixed, with a current cost of 6.1 percent of pay for the Federal government over the new employees' career. If total retirement costs were designed to match the government's cost under the existing CSRS, there would be 18.6 percent of pay available to be allocated to the various components of a new supplemental system after paying 6.1 percent for social security.

Over the past year, we have encountered a great deal of interest, within and outside the Congress, in establishing a tax-deferred capital accumulation plan (CAP) for Federal employees as part of the supplemental retirement system. This type of arrangement, called a 401(k) plan in tribute to the authorizing section of the Internal Revenue Code, has become very popular in the private sector. Since these plans began to become popular three years ago, the percentage of firms offering a 401(k) option has increased from 3 percent to 32 percent. We expect more than two-thirds of our private sector survey participants to have a 401(k) plan in effect within the next few years.

The Committee could decide to incorporate a CAP option as part of the overall Federal retirement package. If so, there is a range of design choices available, depending on the share of the

government's total cost the Committee might choose to allocate for the CAP component. There could be no government contribution, or there could be matching contributions equal to, for example, 50, 100, or even 200 percent of employee contributions. In the private sector the employer match typically is limited to the first 6 percent of pay deferred by the employee. The matching rate is typically 50 percent. Allowing for less than full employee participation, the cost to the government of a plan along these lines would be about 2 percent of pay. Under more extensive CAP options, with higher matching rates, the government cost could range up to 6 percent of pay.

If the value of the existing CSRS is to be preserved in the total retirement package available to Federal employees covered by a plan supplemental to Social Security, the allocation of costs would depend on specific CAP design choices, as depicted in the following chart. If all benefits were to be paid from a traditional retirement system, 19 percent of pay would be available for that system. Use of a typical private sector CAP plan that costs an estimated 2 percent of pay would leave about 17 percent of pay for the traditional retirement plan. Use of a more generous CAP could reduce the funds available for the basic retirement system to 13 percent of pay.

## **ALLOCATION OF EMPLOYER CONTRIBUTION (percent of payroll)**

	<b>Current CSRS</b>	<b>New Employee system</b>		
		<b>No CAP</b>	<b>Moderate CAP</b>	<b>Large CAP</b>
<b>Retirement System</b>	<b>25%</b>	<b>19%</b>	<b>17%</b>	<b>13%</b>
<b>Social Security</b>	<b>0</b>	<b>6</b>	<b>6</b>	<b>6</b>
<b>CAP</b>	<b>0</b>	<b>0</b>	<b>2</b>	<b>6</b>
<b>Total</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>

### GENERAL BENEFIT DESIGN

Within the constraint of total system cost, certain decisions must be made about key design issues. The first major design issue that I would like to review today is the allocation of the total value of benefits among various groups of employees and their dependents. This question immediately raises the issue of the "social security tilt" and the methods of designing a system around that tilt.

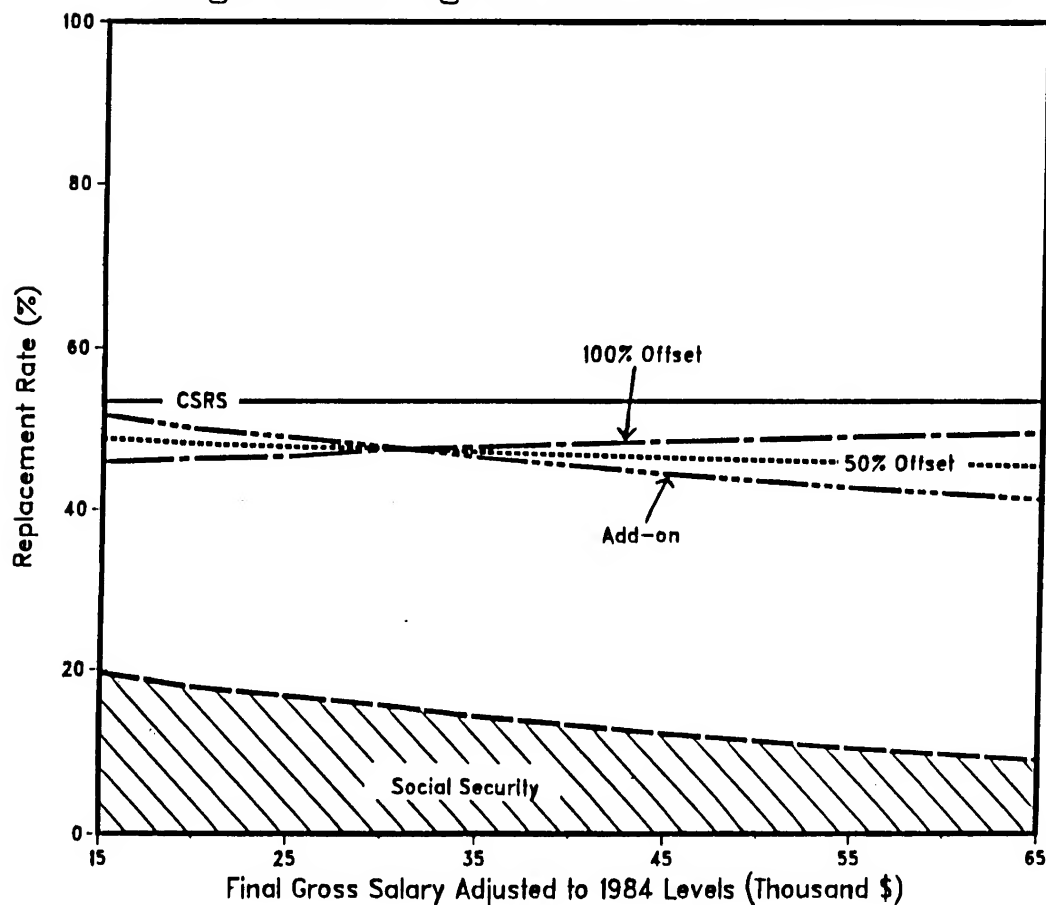
The CSRS provides benefits amounting to roughly the same percentage of pay to retirees at all salary levels, other factors being equal. For instance, any employee with 30 years of service can receive 56.25 percent of his or her high-three salary irrespective of the level of that salary. Also, benefits increase roughly in proportion to service, so that an employee with 30 years of service receives a little more than twice as large a benefit, in percentage of pay terms, as an employee with 15 years of service.

Social security is constructed on different principles. The system does provide higher retirement incomes as salaries and years of work increase. However, a basic floor level of benefits is paid to individuals meeting the minimum vesting requirements, followed by gradually diminishing increases for additional service or salary.

As a result, the social security benefit is not directly proportional to either service or salary. For instance, in the range of most Federal salaries, social security replaces over 20 percent of the final pay of a low-paid single employee but only 10 percent of the pay of a high-paid single employee.

A pension plan can be designed with any one of several different approaches in response to this tilt. The tilt and the range of design responses to the tilt are illustrated in the next chart. The plan can ignore the tilt through an add-on plan that gives the same

# Comparison of Coordination Approaches Gross Replacement Rates Single Worker Age 62 with 30 Years of Service





percentage of income to all employees with the same years of service. Alternatively, it can offset some or all of the tilt by providing relatively higher income replacement percentages to higher-paid employees.

The full range of choices and their impact can be considered by looking at an add-on plan and a full offset plan. An add-on plan is simple in design and administration. An example would be to pay all employees one percent of their pay base for each year of service. Thus, each employee would receive 30 percent of pay for 30 years of service. The employee with a pay base of \$15,000 would receive \$4,500 a year and the \$45,000 employee would receive \$13,500 in annuity. This would be added to the social security benefit of 20 percent of pay for the lower paid and 10 percent of pay for the higher paid employee, yielding total benefits of 50 percent and 40 percent of pay, respectively.

Compared to the existing CSRS, social security together with an add-on supplemental plan would produce gainers and losers. The gainers would be lower-paid, shorter service, and married employees. Conversely, the losers would be higher-paid, longer-service, and single employees.

At the other extreme, a full offset plan would simply pay each employee or dependent a benefit equal to the existing CSRS benefit, minus the social security benefit when and if it became payable. This design would not create any large groups of winners or losers, relative to the existing CSRS. There would be a few employees who would gain because social security benefits are greater than CSRS benefits in some cases.

There are several problems with the full offset approach. First, compared to an add-on plan, an offset is more complex to administer because it requires determination or estimation of the social security benefit. Second, a full offset system would increase costs because of the need to add funds to offset the

redistribution of social security away from career retirement benefits toward portability. Finally, the Federal government would be using a design that is denied, by the tax law, to private sector employers with qualified pension plans.

A frequent approach in the private sector is to offset part of the social security benefit. For a plan which only pays benefits at 65, the offset could be as high as 83 percent of the social security benefits. For most plans similar to CSRS, however, the maximum allowable offset is less than two-thirds because of a series of modifications of the offset related to auxiliary benefits. As a result, a typical private sector design is to offset half of the social security benefit for a full career. This approach moderates half of the tilt of social security and is acceptable within Federal pension law. There would be gainers and losers, relative to existing CSRS benefits, but at only half the level as under an add-on plan.

There are several approaches to the offset formula which we will be happy to review in detail at another time. Two of the most common approaches are a direct offset or a step-rate design that provides higher replacement income for salaries above a selected point. While these various offset approaches have complex, esoteric differences, any of them can be used to achieve very similar results.

### PORTABILITY AND VESTING

CSRS provides full vesting to all employees who reach five years of civilian service. However, many of these employees forfeit valuable benefits by electing a refund of their contributions. Thus, there is little portability of earned benefits for employees who leave before meeting full retirement eligibility.

By contrast, social security -- an important component of the overall retirement system for new Federal employees -- is fully portable to other employment throughout the United States. New Federal employees will from now on -- like almost all other workers -- participate continuously in social security and carry fully portable credits from job to job straight through to retirement.

The OPM comparison of retirement systems noted that almost 60 percent of new employees to CSRS will not receive significant benefits in return for the employees' contribution. By contrast, 90 percent or more of employees entering a typical private sector pension system will eventually receive benefits from the retirement system.

This difference in distribution of benefits is not related to the supplemental retirement plan itself but is almost entirely attributable to structural differences between CSRS and social security. CSRS provides a good level of benefits to career employees but nothing to employees who leave before five years of service. Employees who leave after five years but before retirement eligibility are entitled to a vested benefit but over 80 percent of these employees choose a refund of contribution in lieu of the vested benefits.

In marked contrast, social security benefits go with the employee to the next job and almost all employees covered by social security will eventually receive a benefit; or benefits will be paid to their survivors. Therefore, the existence of social security alone will result in a major shift in the distribution of benefits.

The chart on the next page shows the difference in percentage of a group of new entrants who receive benefits under CSRS and under alternative supplemental Federal retirement systems that include social security. The chart shows the distribution of benefits under a supplemental plan with late vesting (10 years of service) and early vesting (5 years of service plus an early vesting CAP). Under either approach, 90 percent or more of entering employees will eventually receive a benefit, compared to 43 percent in CSRS.

To the extent that a wider distribution of benefits may be desired, the new system already has achieved this goal through the introduction of social security benefits. Further, if the new retirement system does not require loss of employer benefits when a refund is taken, then the patterns of benefit receipt will be much more widely distributed and, in fact, will be very similar to the patterns in the private sector.

The difference in distribution of benefit does not suggest that either CSRS or social security provides the correct distribution. CSRS was designed to provide full career benefits and to only vest employees who leave their money in the system. By its nature, CSRS credit cannot be portable to other systems so that short-term employees or those who take refunds do not receive any benefit from the system. Social security was designed to provide fully portable benefits through much of the workforce. Let me emphasize, however, that we are not here today to discuss the appropriateness of the benefits of CSRS but to discuss the preferred design of the new supplemental system. In that context, in whatever system is designed, the redistribution to shorter service people will automatically be part of the system.

Since portability for any supplemental system will be sharply improved compared to CSRS, the Committee may wish to consider the appropriate level of additional portability and vesting to be provided in the new retirement system. At a minimum, we recommend

## PERCENT OF EMPLOYEES RECEIVING A BENEFIT

	<b>Current CSRS</b>	<b>Supplemental Plan</b>	
		<b>Late Vesting</b>	<b>Early Vesting</b>
<b>Leave With no Benefit</b>			
<b>Before Vesting</b>	<b>39%</b>	<b>10%</b>	<b>7%</b>
<b>After Vesting</b>	<b>18</b>	<b>0</b>	<b>0</b>
<b>Total</b>	<b>57%</b>	<b>10%</b>	<b>7%</b>
<b>Receive a Benefit</b>			
<b>Death</b>	<b>3%</b>	<b>3%</b>	<b>3%</b>
<b>Disability</b>	<b>4</b>	<b>4</b>	<b>4</b>
<b>Retirement</b>	<b>32</b>	<b>27</b>	<b>27</b>
<b>Deferred</b>	<b>4</b>	<b>56*</b>	<b>59*</b>
<b>Total</b>	<b>43%</b>	<b>90%</b>	<b>93%</b>

\* mostly from social security

that, once vested, the employer-provided benefits should not be forfeited because of a refund of employee contributions. Many of the designs you consider will be consistent with the overwhelming majority of private sector plans, which do not require a contribution. The question of divesting will be moot if there is no employee contribution to refund.

However, if a contribution is required, it will probably be much smaller, relative to the vested benefit, than in the existing CSRS. We suggest that the Committee avoid imposing a substantial penalty upon employees, by permitting withdrawal of contributions and also vesting the employee in the employer's share.

The Committee's practical choice in selecting a vesting period for the new plan ranges from the five year condition of CSRS to the ten year provision commonly found in the private sector. In general, under the ERISA regulations, the private sector cannot require more than 10 years for vesting, so most employers have selected that period. There is little cost difference between five and ten year vesting. For most designs under consideration, five year vesting will increase costs by less than .5 percent of pay over 10 year vesting.

While a large number of employees leave with between five and ten years' service, the difference in those entitled to any benefit is small because the great majority of people in the five to ten year group will eventually receive a social security benefit for that service. Hay calculates that only one percent of employees will receive benefits under a five year vesting rule who would not receive benefits under a ten year rule.

Since the cost to the government, and the effect on the employees, are relatively small, the main consideration might be one of administration. The government would have to keep records on the employees who leave with five to ten years' service, and the eventual benefits will be small for most of these employees. One

approach used widely in the private sector is to pay a lump-sum amount equal to the benefit value for terminees with an employer-provided benefit worth less than \$3,500.

The question of vesting for a capital accumulation plan is much different. Because of the design of these plans, short service employees receive a much larger benefit, compared to career employees, than in a traditional supplemental retirement plan. Partly as a result of this effect, private sector employers tend to vest these benefits after five or even as little as two or three years. Use of two year vesting will increase the number eventually receiving a benefit by 3 percent compared to ten year vesting. This is the difference between the two designs on our chart.

#### Effect on Employee Demographics

In determining appropriate vesting requirements, the Committee will have to consider the effects of vesting rules on government career patterns and employee retention. The current CSRS provides replacement income of over 50 percent of salary to the career employee as early as age 55. The system thus encourages employees to stay in Federal government employment as they approach age 55 and offers a declining incentive to remain thereafter.

In contrast, new Federal employees already have enhanced benefit portability due to continuous social security coverage. This coverage, in and of itself, will probably increase turnover among employees in their thirties and forties and hold down the losses between 55 and 62. To the extent that a thrift plan is used, it will also add to the portability because, after vesting, the funds travel with the employee in or out of Federal service. The supplemental retirement system will then be the only part of the retirement package that will retain any effect on employee retention.

In addition, portability and vesting provisions have different effects on different career paths. Employees who enter Federal employment late, or leave early, or have a split career, will now have improved benefits because of social security. The vesting and portability aspects of the new system could enhance or partially offset this result.

The direction of the new system's effect on employees involves several design choices. At one extreme, the effects of the current system could be at least partially retained by using a longer vesting condition and by retaining the full retirement age of 55. Choice of a later retirement age and more liberal vesting conditions will dampen the effect of the retirement system on the decisions of employees to stay or leave - particularly from age 40 to age 62. Another important design choice is the decision on supplementation of the benefit between retirement and the earliest age for receipt of social security benefits. We have found that without such supplementation, employees will tend to stay until age 62 in order to retire on full benefits from both retirement and social security.

One final comment in this connection is the age at which vested benefits become paid. The typical private sector approach is to allow reduced benefits to be paid as early as age 55 if the choice is entirely up to the employee, and to use actuarial reductions to make the effect of employee choices neutral to the fund. In other words, a terminating employee not eligible for full early retirement benefits can typically elect to receive reduced benefits payable at any age after 55 at no cost to the fund. The Committee may want to consider this approach.



## FUNDING OF SUPPLEMENTAL BENEFITS

### Total Cost

Earlier, we looked at the appropriateness of the various funding concepts used under CSRS today. As we noted, the current system is in adequate actuarial balance over the long term. In considering the appropriate financing of the supplemental system, the most important consideration is that the adequacy of the long-term financing be maintained. A second important goal is that the sources of the financing equitably reflect the rising cost of the retirement system.

A retirement system that only covers new employees has the advantage not being encumbered with a burden from the past. The current unfunded liability of CSRS is the result of a number of decisions over the last 65 years as to funding and level of benefits in addition to the investment performance of the fund over that time. A system for new employees, by definition, has no past credit and no unfunded liability. If a system is constructed to totally pay for the arising normal cost, and to immediately fund any deviations from that cost, the supplemental system will not add to the unfunded liability in the future.

Based on last year's hearings and subsequent discussions with your staff, we assume that the Committee will want to maintain the adequacy of current financing provisions by including the new supplemental benefits under the existing CSRS fund. Since the current financing is based on the assumption that the coverage of the system will be open-ended, this step will avoid the possibility of inadequacy in the financing for benefits of employees hired before 1984.

The Committee could consider methods of deferring part of the cost of the new system but we suggest full normal cost financing of supplemental retirement benefits for several reasons. First, the

normal cost is currently the only funding needed. Second, the employers' share of the normal cost is relatively low when compared to current financing. If the constant cost approach is taken, the employer cost including social security will be 25 percent of payroll compared to an aggregate cost for the existing CSRS of 32 percent of payroll. The additional 7 percent currently paid is attributable to the financing of the unfunded liability, in order to ensure the long-term stability of the fund. Since new employees covered under a supplemental system would not bring with them any unfunded liabilities, 25 percent of payroll will adequately finance the cost of the new system.

After selecting the total cost target, the next step is to allocate the cost among the employee and the employer. Within the government there are several sources to draw on for the employer share. The chart on the following page illustrates the range of choices for a constant cost system.

#### Employee Share

In developing a new cost system, there will be some effect from the temporary legislation that has been in place since January 1984. This legislation requires that new employees contribute 1.3 percent of pay to CSRS. Through this process most employees, whether covered under the old or new system, are paying 8.3 percent of salary to retirement benefits and social security/Medicare. The exceptions are new employees with earnings greater than the social security maximum taxable wage base (\$39,600 in 1985), since their total contribution drops to 1.3 percent of pay after that salary is reached.

In considering the appropriate contribution for employees under the new system, the Committee should look at the contributions required in the private sector as well as under CSRS for employees hired before 1984. The private sector pension plans typically do not require any employee contribution. From this perspective, the

**SOURCE OF CONTRIBUTIONS  
SUPPLEMENTAL RETIREMENT SYSTEM  
(percent of payroll)**

	<b><u>Social Security</u></b>	<b><u>Retirement System</u></b>	<b><u>CAP</u></b>
<b>Employee</b>	<b>6%</b>	<b>0 to 2%</b>	<b>0 to 6%</b>
<b>Government</b>			
• <b>Employing Agency</b>	<b>6%</b>	<b>0</b>	<b>0 to 6%</b>
• <b>General Revenues or Agency</b>	<b>0</b>	<b>13 to 19%</b>	<b>0</b>

required contributions to social security and any voluntary contributions to a thrift plan would be equitable. However, for employees not contributing to a thrift plan, the contributions would be less than for their counterparts under the old system.

One approach to this contribution difference would be to demonstrate that the total benefits under the existing CSRS are greater than under the combined new system largely because of the employee contributions. If, for instance, the new system in combination with social security provides less income on average at retirement, or reduces early retirement benefits or COLAs, then current employees would probably be satisfied that they were getting their money's worth for the extra contributions.

A second approach would be to require contributions equal to the total under CSRS less the total contributed to social security. This would be the same as in the temporary legislation, with a modification to require increased contributions to the supplemental plan on salaries above the social security maximum salary. This extra contribution could be used to bring new system benefits closer to the current system so that employees could consider that they were receiving similar benefits for similar contributions. This approach could bring in average contributions of up to 2 percent of payroll -- the high end of the range indicated on the chart.

While this approach might create a perceived equity, it could also create confusion for those who tried to understand the equity, because of the redistributive effect of social security. In most supplemental plan designs the high paid employee would find, for instance, that his or her benefit was lower than the current base. This problem could only be avoided by using a full offset of social security benefits. A second problem with this approach is that it creates a rather awkward employee contribution basis. For instance, the contribution in 1986 would be 7.15 percent to social security/Medicare up to \$41,100 (assuming that is the social security cap in 1986); 1.3 percent to the supplemental plan up to \$41,100; and 8.45 percent to the supplemental plan above \$40,000.

### Source of Employer Contribution

Once the share of contribution is determined and overall funding policy set there is a need to specify the source of the government contribution. CSRS is currently funded from several sources. The employing agencies match the employees' contribution (usually 7 percent of pay) and the remainder is financed through a series of payments from general revenues. One exception is that some off-budget employers, notably the Postal Service, pay part of the additional costs.

The General Accounting Office has recommended that more of the financing derive directly from the employing agency. With the exception of the off-budget employers, this step would not have any impact on the Federal deficit because all of the sources of employer financing are internal transactions. However, GAO argues that charging the full costs to the agency budgets would better highlight the true cost of the supplemental system.

As shown in the chart, we assume that the employer's social security contribution -- and share of CAP, if any -- will be paid by the employing agency. This leaves a contribution of 13 percent to 19 percent of pay to be paid by the employer under the constant cost approach. You could appropriate this amount from general revenues each year or require the payment directly from the employing agencies. In the latter case, the entire 25 percent employer contribution would be paid by the agency.

We agree that putting the total employer cost of the new system in one line item would be preferable for those attempting to focus on the total cost of the system. The main disadvantage is that it might appear to older system employees that the government was making a higher contribution to the new employee system. In turn, that could lead to changes in the current system financing. We emphasize that whether the total employer cost should be put in one line item is primarily a question of perception, with no real impact on the budget outside of the financing from off-budget agencies.

### SYSTEMS OTHER THAN CSRS

One final aspect of the system that Hay believes deserves some comment is the treatment of benefits for groups that have separate benefit and/or contribution formulae, either within CSRS or in separate systems. The major groups that may require new supplemental plans are:

- o Hazardous duty employees within CSRS (primarily FBI and firefighters).
- o Air Traffic Controllers within CSRS.
- o Members of Congress and legislative employees within CSRS.
- o The Foreign Service and Central Intelligence Agency systems.
- o The judicial systems.

These retirement provisions have evolved over the years in response to special characteristics of the work involved. For instance, the hazardous duty, Foreign Service, and CIA plans reflect a conscious effort to use the retirement system to reinforce a certain type of career pattern for the good of the Federal government. It has been argued that these employee groups need to enter their careers at a young age, to continue in those careers to avoid substantial turnover and training costs, and in most instances to retire earlier than age 55 or 60. Thus, the retirement systems for such groups are relatively generous to the employees in order to be specially useful to the employer.

Similarly, the CSRS provisions for Members of Congress and legislative employees recognize the problems associated with interrupted careers and the need to provide adequate long-term benefits from all portions of the career. The judicial systems were designed primarily to recognize the need for survivor benefits for judges who often continue in active service until death.

## **SYSTEMS OTHER THAN STANDARD CSRS**

### **WITHIN CSRS**

- **Air Traffic Controllers**
- **Harzardous Duty**
- **Members/Legislative**

### **OUTSIDE CSRS**

- **Foreign Service**
- **CIA**
- **Judiciary**
- **Small Systems**

### **OUTSIDE CSRS — NO CHANGE NEEDED**

- **District of Columbia**
- **Military**
- **TVA, Banks, etc.**
- **Closed systems**

Including the separate judicial systems, we have referred to nine systems in the above list. The Committee is no doubt familiar with reports stating that there are over 50 Federal retirement systems. However, most of the rest are types of systems that do not require adjustment in response to social security coverage. One type, such as the military retirement systems, have had social security coverage for some time and presumably have been designed to recognize that coverage. Another type, such as the provision for widows or lighthouse employees, only cover retired members and thus do not have to be integrated. A final type, such as the plans for the Controller General and the President, are so limited that modifications can be made on a case-by-case basis.

Thus, after design of the general supplemental system for new employees, the focus is on the nine systems we have listed. Hay recommends that the Committee review the special career patterns within each of the affected groups. The Committee can then decide if the employees' needs and the government's objectives warrant differential treatment in the design of supplemental retirement benefits. In doing so, it will be important to recognize that social security coverage for these groups has already changed the impact of the total package of retirement benefits. The earliest point at which social security benefits can be received is currently age 62, and this has a particularly profound impact on groups that have traditionally retired at substantially younger ages. We understand that the Committee will be hearing from representatives of several of the affected agencies later in this hearing.

To assist the Committee in this review, we have attached a brief summary of the special provisions and benefits currently in effect for each of the affected groups.



## CONCLUSION

Today we have looked at several of the complex issues that have to be resolved before the specific details of a new system can be developed. The interim contribution and benefit adjustment enacted in 1983 will expire at the end of this year. The issues of design and financing are complex and, if not carefully addressed, can lead to costly or inequitable results that could affect several generations of employees and taxpayers. However, with the continued careful effort of this Committee, it will be possible to develop a fair and adequate supplemental retirement system for Federal employees covered by social security. Hay looks forward to continuing to assist the Committee with this very complex and important question.

**BASIC PROVISIONS OF OTHER MAJOR FEDERAL RETIREMENT SYSTEMS WITH EMPLOYEES  
NEWLY COVERED BY SOCIAL SECURITY (CSRS special provisions and non-CSRS)**

<b>RETIREMENT SYSTEM</b>	<b>EMPLOYEE CONTRIBUTION</b>	<b>RETIREMENT AGE/SERVICE REQUIREMENTS</b>	<b>BENEFIT ACCRUAL FORMULA</b>
<b>Within the Civil Service Retirement System:</b>			
<b>AIR TRAFFIC CONTROLLERS</b>	7% of pay	Age 50 with 20 years of service, or any age with 25 years of service	Standard CSRS accrual formula, except with a minimum annuity of 50% of pay
<b>HAZARDOUS DUTY EMPLOYEES (law enforcement officers and firefighters)</b>	7.5% of pay	Age 50 with 20 years of service	2.5% for each of the first 20 years of service, plus 2% of pay for each additional year
<b>MEMBERS OF CONGRESS</b>	8% of pay	Age 62 with 5 years of service, or age 60 with 10 years of service, or age 55 with 30 years of service. Involuntary retirement at age 50 with 20 years of service (or service in 9 Congresses), or with 25 years of service.	2.5% of pay for each year of service. Annuities commencing before age 60 are reduced by 1% per each year from age 55 to 60, and 2% per each year under age 55.
<b>CONGRESSIONAL EMPLOYEES</b>	7.5% of pay	Same as standard CSRS: age 55 with 30 years of service, or age 60 with 20 years of service, or age 62 with 5 years of service.	2.5% of pay for each year of service
<b>Outside the Civil Service Retirement System:</b>			
<b>FOREIGN SERVICE</b>	7% of pay	Age 50 with 20 years of service	2% of pay for each year of service, with a maximum of 70%
<b>CENTRAL INTELLIGENCE AGENCY</b>	7% of pay	Age 50 with 20 years of service	2% of pay for each year of service, with a maximum of 70%
<b>FEDERAL JUDICIARY</b>	None for basic benefits, 4.5% of pay for elective survivor benefit	Age 65 with 15 years of service, or age 70 with 10 years of service	Current salary of former position
<b>U.S. TAX COURT JUDGES</b>	None for basic benefits, 3% of pay for elective survivor benefit	Age 65 with 15 years of service	Current salary of former position, except with less than 10 years of service benefit equals current salary level multiplied by ratio of years of service to 10 years
<b>EMPLOYEES OF THE FEDERAL RESERVE BOARD OF GOVERNORS</b>	7% of pay	Same as standard CSRS: age 55 with 30 years of service, or age 60 with 20 years of service, or age 62 with 5 years of service.	Same as standard CSRS

**NOTE:** This chart summarizes only the basic retirement provisions. It is not a full picture of all applicable provisions and requirements, and does not describe other types of benefits.

STATEMENT OF  
DONALD J. DEVINE  
OFFICE OF PERSONNEL MANAGEMENT  
AT A HEARING OF THE  
COMMITTEE ON POST OFFICE AND CIVIL SERVICE  
U.S. HOUSE OF REPRESENTATIVES  
ON THE  
DEVELOPMENT OF A NEW RETIREMENT SYSTEM  
FOR FEDERAL EMPLOYEES COVERED BY SOCIAL SECURITY  
APRIL 2, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

THANK YOU FOR INVITING ME TO APPEAR THIS MORNING TO DISCUSS THE DEVELOPMENT OF A NEW RETIREMENT SYSTEM FOR THOSE FEDERAL EMPLOYEES WHO ARE COVERED BY SOCIAL SECURITY.

I BELIEVE IT IS VERY IMPORTANT THAT WE DEAL WITH THIS ISSUE IN A TIMELY FASHION. EMPLOYEES HAVE BEEN HIRED SINCE JANUARY 1, 1984, WITHOUT HAVING ANY FIRM IDEA OF WHAT THEIR RETIREMENT SYSTEM WOULD BE. I BELIEVE ACTION THIS YEAR BY CONGRESS IS ESSENTIAL TO REFORM THE CURRENT RETIREMENT SYSTEM AND TO PROVIDE OUR EMPLOYEES WITH A RETIREMENT PLAN THAT IS BOTH ATTRACTIVE TO THE LARGE MAJORITY OF FEDERAL EMPLOYEES AND IS CONSIDERATE OF THE RESOURCES TAXPAYERS ARE ABLE TO BEAR.

THE PRESIDENT'S BUDGET SAID THAT: "THE ADMINISTRATION PLANS TO SUBMIT LEGISLATION FOR A NEW SYSTEM CONTAINING A DEFINED CONTRIBUTION PLAN AND COSTING -- INCLUDING THE EMPLOYER'S SHARE OF THE SOCIAL SECURITY TAX -- APPROXIMATELY 20 PERCENT OF PAYROLL ON AN ACTUARIAL NORMAL COST BASIS."

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THE FIRST QUESTION NATURALLY IS, "WHY A DEFINED CONTRIBUTION PLAN?" THE REASON IS SIMPLE. THE PRESENT SYSTEM DOES NOT GIVE REAL BENEFITS TO MOST FEDERAL EMPLOYEES. A STUDY OF OUR EXISTING RETIREMENT SYSTEM DONE BY OUR CONSULTANT, IPF&C, SHOWS THAT 45 PERCENT OF A COHORT OF NEW ENTRANTS ACTUALLY SUBSIDIZE THE SYSTEM, WHILE ANOTHER 15 PERCENT RECEIVE SO LITTLE IN BENEFIT THAT THEIR NORMAL COST IS LESS THAN 5 PERCENT OF PAY. THUS, ALMOST 60 PERCENT OF OUR NEW ENTRANTS HAVE BEEN RECEIVING ESSENTIALLY NO BENEFITS FROM THE CURRENT SYSTEM. I BELIEVE THIS IS UNFAIR, AND MUST BE RECTIFIED UNDER THE NEW SYSTEM.

SOME RELIEF WILL BE PROVIDED BY THE FACT THESE NEW EMPLOYEES ARE COVERED BY SOCIAL SECURITY AND THOSE BENEFITS ARE BY THEIR NATURE PORTABLE. ANY NEW PLAN WOULD USE THE SOCIAL SECURITY BENEFITS AS THE BASE DEFINED BENEFIT PLAN. THIS IS THE BASE COVERAGE RELIED UPON FOR THE OVERWHELMING PROPORTION OF THE PRIVATE SECTOR. INDEED, FOR ALMOST HALF OF PRIVATE SECTOR EMPLOYEES, SOCIAL SECURITY DEFINED BENEFITS WILL BE THE ONLY PROTECTION THEY WILL RECEIVE.

THE ADD-ON RETIREMENT COVERAGE TO THE SOCIAL SECURITY DEFINED BENEFIT BASE WOULD BE THE DEFINED CONTRIBUTION PLAN. THE VERY NATURE OF THE DEFINED CONTRIBUTION PLAN REQUIRE THAT THE SYSTEM BE FINANCIALLY SOUND WITH THE FULL COST OF RETIREMENT BENEFITS BEING IDENTIFIED AT THE TIME COVERED EMPLOYEES ARE PERFORMING THE SERVICES. ONE OF THE MAJOR PROBLEMS OF THE CURRENT SYSTEM WAS AN EXPANSION OF BENEFITS

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WITHOUT PLANNING FOR COSTS. A DEFINED CONTRIBUTION PLAN PROVIDES FOR FISCAL RESPONSIBILITY FROM THE BEGINNING. BENEFITS ARE SIMPLY BASED UPON THE CONTRIBUTIONS MADE, WITH THE INCREASE IN BENEFITS BEING PEGGED TO A SPECIFIED MECHANISM -- HERE THE TREASURY INTEREST RATE. THERE WILL BE NO ONE-HALF TRILLION DOLLAR UNFUNDED LIABILITY UNDER THIS NEW RETIREMENT SYSTEM.

ONE OF THE MOST SIGNIFICANT ATTRIBUTES OF A DEFINED CONTRIBUTION PLAN IS THAT IT ALLOWS ALL EMPLOYEES TO RECEIVE BENEFITS AFTER A VERY SHORT VESTING PERIOD. UNDER AN UPM DRAFT OF A SUPPLEMENTAL RETIREMENT SYSTEM NOW UNDER REVIEW IN THE EXECUTIVE BRANCH, A DEFINED CONTRIBUTION PLAN COMBINED WITH VESTING AFTER ONE YEAR WOULD GIVE ALMOST EVERY EMPLOYEE SOME SHARE OF THE BENEFITS, RATHER THAN SHUTTING OUT 60 PERCENT OF EMPLOYEES. THESE BENEFITS WOULD BE ASSURED BECAUSE EACH EMPLOYEE WOULD BE GIVEN AN INDIVIDUAL ACCOUNT. TO WHICH HE OR SHE WOULD BE ENTITLED AT AGE 59½. IN ITS PRACTICAL EFFECTS, IT WOULD BE LIKE AN IRA -- PUT AWAY FOR FUTURE USE.

WE WOULD EXPECT MANY CURRENT EMPLOYEES TO SWITCH TO ANY NEW PLAN OFFERED. THIS IS NATURAL, SINCE SO MANY ARE DISADVANTAGED BY THE PRESENT SYSTEM. UNDER THE UPM DRAFT, THOSE WISHING TO SWITCH WOULD BE CREDITED, IN THEIR INDIVIDUAL ACCOUNT, WITH BOTH THEIR OWN CONTRIBUTION UNDER THE PRESENT PLAN AND THEIR AGENCY CONTRIBUTION, PLUS

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INTEREST. THEREFORE, FOR CURRENT EMPLOYEES IT WOULD BE A VERY SUBSTANTIAL FUND SET UP IN THEIR OWN ACCOUNT, BASED UPON A 14 PERCENT CONTRIBUTION FOR EACH YEAR PLUS INTEREST. SERVICE UNDER THE OLD RETIREMENT SYSTEM WOULD COUNT FOR VESTING UNDER THE NEW PLAN. THIS WOULD BE A GOOD DEAL FOR EMPLOYEES AND MANY WOULD MAKE THE SWITCH.

NEEDLESS TO SAY, UPM'S PROPOSAL WOULD INCLUDE DISABILITY PROTECTION, AND SPOUSAL AND DEATH BENEFITS AND SPECIAL ARRANGEMENTS WOULD BE MADE FOR EMPLOYEES WHO PRESENTLY HAVE SPECIAL RETIREMENT PROVISIONS. BALANCES COULD BE TAKEN, AT RETIREMENT, IN CASH OR AN ANNUITY CREATED, WHICH COULD BE INDEXED TO THE COST-OF-LIVING IN AN ACTUARIAL MANNER. AND, IMPORTANTLY, THERE WOULD BE NO EMPLOYEE CONTRIBUTION OTHER THAN SOCIAL SECURITY -- ALTHOUGH UPM WOULD LIKE TO PROVIDE THE OPPORTUNITY FOR A TAX-DEFERRED ADDITIONAL SAVINGS PLAN FINANCED BY THE EMPLOYEE, BUT THE DEFINED CONTRIBUTION WOULD BE SOLELY AT THE COST OF THE GOVERNMENT.

WE BELIEVE THE ISSUES OF THE SOCIAL SECURITY "TILT" AND OF EMPLOYEE CONTRIBUTIONS ARE CLOSELY RELATED. THIS SOCIAL SECURITY TILT IS, OF COURSE, THE DESIGN OF THE SOCIAL SECURITY BENEFITS STRUCTURE WHICH REPLACES A HIGHER PERCENTAGE OF INCOME AT LOWER INCOME LEVELS THAN AT HIGHER LEVELS. THIS TILT IS BUILT INTO SOCIAL SECURITY AS A FORM OF SOCIAL INSURANCE FOR THOSE AT LOWER INCOME LEVELS, WITH THE RECOGNITION THAT THOSE AT HIGHER LEVELS ARE ABLE TO,

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AND SHOULD BE ENCOURAGED TO, PROVIDE IN PART FOR THEIR RETIREMENT YEARS THROUGH THEIR OWN SAVINGS.

IT APPEARS TO US THAT IT WOULD BE REASONABLE TO ADDRESS THIS AREA BY NOT ATTEMPTING TO OFFSET THE TILT AT ALL IN THE UPM PLAN, BUT BY INCLUDING A MECHANISM THAT WOULD ENCOURAGE THOSE EMPLOYEES WHO CAN AFFORD TO DO SO TO SAVE FOR THEIR RETIREMENT, THUS PROVIDING FOR THEMSELVES AN INCOME REPLACEMENT RATIO CONSISTENT WITH THOSE WHO BENEFIT FROM THE TILT.

THE MOST OUTSTANDING FEATURE OF UPM'S PROPOSED NEW SYSTEM IS THAT THE OVERWHELMING PERCENTAGE OF EMPLOYEES WOULD GET BENEFITS. THEIR OWN ACCOUNT WOULD BE OPENED, AND THEY WOULD GET AN ANNUAL STATEMENT OF ITS BALANCE. MOREOVER, EMPLOYEES WOULD OBTAIN OPTIONS -- THEY WOULD NOT BE HANDCUFFED TO A JOB THEY DISLIKE. BECAUSE THE BENEFITS WOULD BE FULLY PORTABLE, EMPLOYEES WOULD FEEL FREE TO MAKE RATIONAL EMPLOYMENT DECISIONS.

WE BELIEVE THIS IS AN EXTREMELY ATTRACTIVE PACKAGE. AT A COST OF ABOUT 19 PERCENT OF PAYROLL, IT WOULD BE EQUIVALENT TO THE AVERAGE PLAN OFFERED BY MAJOR U.S. EMPLOYERS. THIS WOULD MAKE US VERY COMPETITIVE WITH THOSE MAJOR EMPLOYERS. INDEED, IT WOULD MAKE US MORE ATTRACTIVE. FOR THE FEDERAL GOVERNMENT WOULD LEAD THE WAY TOWARD VERY EARLY VESTING, HIGH PORTABILITY, INDIVIDUAL ACCOUNTS AND SET RETURNS. THIS WOULD BE EXCELLENT COVERAGE FOR NEW

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EMPLOYEES, AND WILL APPEAL TO A LARGE PERCENTAGE OF  
EMPLOYEES NOW COVERED UNDER THE PRESENT SYSTEM.

THIS IS THE GENERAL OUTLINE OF UPM'S PROPOSAL. SOME  
OF THE PROVISIONS MAY BE CHANGED AS A RESULT OF AGENCY  
REVIEW, AND MANY OF THE DETAILS HAVE YET TO BE WORKED OUT,  
BUT I WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU MAY HAVE.



UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY  
EXPECTED AT 10:00 a.m.  
April 2, 1985

STATEMENT OF  
CHARLES A. BOWSHER  
COMPTROLLER GENERAL OF THE UNITED STATES  
BEFORE THE  
POST OFFICE AND CIVIL SERVICE COMMITTEE  
HOUSE OF REPRESENTATIVES  
ON  
THE DESIGN OF A NEW RETIREMENT PROGRAM FOR  
FEDERAL EMPLOYEES COVERED BY SOCIAL SECURITY

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our work as it relates to the design of a new retirement program for federal employees covered by social security. The Social Security Amendments of 1983 required all federal civilian employees hired for the first time after December 31, 1983, to participate in social security. The Congress has set January 1, 1986, as the target date for establishing a new retirement program for these employees.

In considering what form this new program should take, we assert as a premise that it should be no more or less generous than prevailing private sector retirement practices. As I will be discussing later, we have identified the characteristics of a "typical" private sector plan and propose this for your consideration as a reasonable standard on which to base federal retirement benefits.

But having said this, it is important to recognize that retirement benefits are but one part of a total compensation package that also includes pay itself, as well as other benefits such as sick and annual leave and health and life insurance. These other components of the compensation package will also require your separate consideration.

We have obtained considerable information on nonfederal retirement programs from selected surveys and studies. Our primary source of information was a 1982 report by the Department of Labor's Bureau of Labor Statistics (BLS) entitled "Employee Benefits in Medium and Large Firms" and the data bases

supporting the report. The report covered a survey universe of 976 pension plans with 17 million participants. Other surveys we used included ones performed by Bankers Trust Company, Hay Associates, Hewitt Associates, the Wyatt Company, and the National Association of State Retirement Plan Administrators. The scope of the surveys ranged from very large firms to companies hiring as few as 50 people. While the surveys were not presented as statistically representative of the entire nonfederal sector, we believe they were sufficiently consistent in their findings that prevailing program features could be identified.

Detailed results of our analysis can be found in two of our reports, Features of Nonfederal Retirement Programs (GAO/OCG-84-2, June 26, 1984) and Benefit Levels of Nonfederal Retirement Programs (GAO/GGD-85-30, Feb. 26, 1985). I would like to offer them for insertion in the record at this time.

The surveys showed that retirement programs available in nonfederal organizations typically consist of three parts--social security, a pension plan, and a capital accumulation plan. Since social security is common to both the new federal program and the nonfederal sector's programs, we concentrated our analysis on the pension and capital accumulation portions of nonfederal programs.

We found that the features of a "typical" private sector pension plan are as follows:

- Vesting, the point in time at which a participant has earned the right to a benefit, occurs at 10 years.
- Employees do not contribute to the pension plan.
- Age 62 is the earliest age at which employees receive pension benefits without reduction.
- Early retirement with reduced benefits is available at age 55 with 10 years of service. Benefit amounts are reduced by 4 percent for each year the retiree is under age 62.
- Pension plan benefits are based on the highest 5-year average salary.
- In recognition of the "tilt" in social security benefits to lower income employees, pension plans are integrated with social security by offsetting the amounts the plan would otherwise pay by some portion of social security benefits.
- The "typical" benefit formula in plans surveyed by BLS is 1.5 percent of high-5 year average salary for each year of service less 1.25 percent times social security benefits for each year of service.
- Retirees' benefit amounts are actuarially reduced when survivor benefit coverage is elected.
- A separate long-term disability insurance program is provided in lieu of disability retirement.
- Periodic post-retirement adjustments average 40 percent of the increase in the Consumer Price Index. In larger plans (10,000 or more employees) adjustments average close to 60 percent.

The significance of the capital accumulation plan portion of the typical three-part private sector retirement program is often overlooked in analyses of private sector retirement practices. Capital accumulation plans include thrift plans, profit sharing plans and stock ownership plans. Some employers sponsor more than one type of plan.

Thrift plans, which are the most common type of capital accumulation plan, encourage employees to save for retirement and other needs by providing for employer matching of some portion of the employees' contributions to the plan. The studies showed that employer-matching percentages were usually fixed rates ranging from 10 percent to over 100 percent of employee contributions with 50 percent matching being the most prevalent.

A recent innovation in the capital accumulation portion of retirement programs has been the use of deferred compensation plans authorized by section 401(k) of the Internal Revenue Code. Under the 401(k) approach, an employee can elect to defer a portion of his/her salary and have the employer deposit the deferred amount into an investment account. The amount of the salary deferral, employer matching contributions, and investment earnings are exempt from personal income taxes until the employee withdraws the funds.

We understand that a tax reform proposal to eliminate 401(k) plans is being considered. However, 401(k) plans are not the only type of tax-deferred compensation plan that could be made available to federal employees. Such a plan could be established under other provisions of the Internal Revenue Code. Furthermore, even if the tax deferral on employee contributions was eliminated, a typical thrift plan would still provide for tax deferrals on employer contributions and investment earnings.

To illustrate the benefit amounts available to employees at retirement from the private sector programs in the BLS survey, we calculated benefits at ages 62 and 55 with 30 years of service using final salaries of \$20,000, \$30,000, \$40,000 and \$50,000. We assumed employee contributions of 3 percent of pay to a thrift plan during all working years with a 50-percent matching contribution by the employer and interest earnings of 7.5 percent. We found that at age 62 the average benefits ranged from 69 percent of final salary at the \$20,000 level to 62 percent at the \$50,000 level. At age 55, the benefits ranged from 35 percent of final salary at the \$20,000 level to 40 percent at the \$50,000 level, exclusive of the benefits available from social security at age 62. (For further details on these estimates, see the attachment to this statement.) For comparison, the current civil service retirement system would provide a benefit of 53 percent of final salary to 30-year employees at all salary levels at age 55 or age 62.

To enhance benefits for employees who retire before social security benefits are available, many private sector employers offer a benefit leveling option. This option allows an employee to receive higher pension plan benefits until social security benefits become available at which time the pension benefits are reduced accordingly. If the age 55 private sector employee in the illustration elected this option, the benefits at retirement would range from 49 percent of final salary at the \$20,000 level to 46 percent at the \$50,000 level.

The President's 1986 budget proposed that the current civil service retirement formula be changed to base benefits on a

5-year average salary and reduce benefits by 5 percent for each year the retiring employee is under age 65. If these changes were enacted, civil service benefits for the 30-year employee would be reduced to 41 percent of final salary at age 62 and 24 percent at age 55--far less than what a typical private sector plan would provide.

In designing the new program, particular attention must also be paid to the employees of the District of Columbia who now participate in the civil service retirement system. The Social Security Amendments of 1983, which required all new federal employees to be in social security, did not apply to District employees. In a 1978 report,<sup>1</sup> we concluded that the District should establish a separate retirement system for its employees, and we continue to believe this should be done. The exclusion of District employees from social security coverage is a further reason to take this action. Otherwise, District employees will eventually be the only employee group covered by the current civil service retirement system.

With regard to program cost, it seems to us that the Congress must make a policy decision on whether the new system should approximate the cost of the features in nonfederal programs or the cost of the current civil service retirement system. In making this decision, it should be kept in mind that the level of benefits available, rather than cost to the

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<sup>1</sup>Federal and District of Columbia Employees Need to be in Separate Pay and Benefit Systems (FPCD-77-71, Jan. 12, 1978).

government, is undoubtedly what will be of primary importance to newly hired and prospective federal employees. Also, since the addition of social security coverage will, of necessity, make the new system quite different from the current system, cost comparisons between the two systems may well be inappropriate.

Turning now to the question of funding the new pension plan. We have long held the view that federal retirement systems should be fully funded, that is, each participating organization should pay all costs not covered by employee contributions. Full funding would enhance cost recognition and budgetary discipline as well as promote sounder fiscal and legislative decisionmaking. Unintended subsidies of agency programs which are required by law to be financed by users of their services will be avoided. Furthermore, program management should be improved because managers would be more aware of total personnel costs when considering alternative workforce structures.

In summary, regarding the issues you asked us to address, we believe that:

- The vesting period should be 10 years.
- Employees should not be required to contribute to the pension plan.
- The pension plan should be integrated with social security.
- The cost of the new retirement program should approximate the cost of the features in a "typical" private sector plan.
- The pension plan should be fully funded and the cost borne by employing organizations.



--The District of Columbia should establish a separate retirement program for its employees.

Finally, let me again emphasize that our remarks apply to the design of a new retirement program for federal employees covered by social security. We have not addressed issues related to what, if any, changes should be made in the current civil service system.

This concludes my prepared remarks; I will be pleased to answer any questions you may have.

ATTACHMENT

ATTACHMENT

**BENEFIT LEVELS (PERCENT OF FINAL SALARY)**  
**FROM ILLUSTRATIVE PROGRAM**

	<u>\$20,000</u>	<u>Final Salary</u> <u>\$30,000</u>	<u>\$40,000</u>	<u>\$50,000</u>
<b><u>Age 62/30 years' service</u></b>				
Social security	26.0	18.3	13.8	11.0
Pension plan	25.0	29.1	31.6	33.0
Thrift plan*	18.3	18.3	18.3	18.3
Total	<u>69.3</u>	<u>65.7</u>	<u>63.7</u>	<u>62.3</u>
<b><u>Age 55/30 years' service</u></b>				
Pension plan	18.9	21.5	23.1	24.1
Thrift plan*	16.0	16.0	16.0	16.0
Total	<u>34.9</u>	<u>37.0</u>	<u>39.1</u>	<u>40.1</u>
Social security at age 62	27.0	19.4	14.6	11.7
<b><u>Age 55/30 years' service (Benefit leveling elected)</u></b>				
Pension plan	32.6	31.3	30.5	30.0
Thrift plan*	16.0	16.0	16.0	16.0
Total	<u>48.6</u>	<u>47.3</u>	<u>46.5</u>	<u>46.0</u>

\*Assumes 3% employee contribution, 50% employer match, and earnings of 7.5% per year.